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General Business Conditions

THE business news of the past month again reveals progress in some lines and hampering difficulties and delays in others. Industrial earnings reflect general conditions, and the compilation of earnings reports on a later page of this Letter shows extreme and unusual irregularities. Manufacturing corporations which have not been handicapped greatly by strikes, either in their own plants or those of their suppliers, have made a good showing. For the most part these are in the soft goods lines, and production of soft goods is gradually working upwards.

Metal-working companies, on the other hand, show the effects of greater reconversion problems and greater disruption of operations. They are making progress, but in many cases it is slow and halting. The most common complaint now is scarcity of materials, parts and equipment, caused largely by the strikes. Also, the industries are struggling with the task — especially formidable in a time of labor unrest — of absorbing new workers, training old ones to new jobs, and in general rebuilding an efficient production organization for competitive peacetime conditions.

In the markets demands continue insatiable and merchandise shortages persist. According to the Department of Commerce, consumers' expenditures in the first quarter were at an annual rate of $120 billions, compared with $105 billions in 1945. April has shown no letdown. Adjusting published figures to allow for different dates of Easter, it may be estimated that Easter department store sales have exceeded last year's by 25 per cent. These are dollar figures. They reflect the tendency of people to buy more expensive merchandise; but even when allowance is made for "upgrading" the figures show that a huge volume of goods of everyday use is moving.

The state of trade also shows that consumers are spending a greater proportion, and saving less, out of their incomes. This had been expected. They want things they have been deprived of; they have larger savings than ever before and derive feelings of security from them.

Effects of the Coal Strike

As April closes the overshadowing influence on the production outlook is the coal strike. Practically no soft coal has been mined since March 31 and another two or three weeks of the strike would leave many industries, and much transportation and utility service as well, nearly prostrate. Industrial stocks of coal at the beginning of the strike were substantial, and have cushioned the effect on industrial operations. However, steel mills have cut ingot output in four weeks from 87 to 68 per cent of capacity, and this is a grave matter for steel users, after the loss of production during the steel strike. In all lines reserve supplies of coal have now been drawn on, cement mills and other manufacturers are running short, and even on the railroads drastic conservation measures are in order.

The Federal Reserve Board's index of industrial production has become chiefly a mirror of strike conditions. It rose in March to 169 (1935-39=100) from 153 in February, the recovery reflecting the end of the steel and other strikes. However, it has dropped again in April, and where it will be in May depends upon the coal supply. From the recent course of the index the inference seems warranted that except for strikes there would have been a steady rise.

Evidently industry wants to go ahead, as far as management is concerned it is ready to go ahead, and it will go ahead as fast as it is permitted. There is no shortage of markets, no lack of technical development and progress and no failure of enterprise. What is making the upward movement halting and disappointing is the continuance of disorder in the industrial organization. It is exemplified not only in the way in which the coal situation has been allowed to drift. for a full month, toward the point of industrial prostration. It shows also in the threat of a strike of railway trainmen and locomotive engineers May 18,

following the unions' rejection of the 16c an hour wage increase awarded them under the fact-finding procedures established by the Railway Labor Act. It appears in the call for an anthracite coal strike June 1, and in the hundreds of minor strikes which are reported as the smaller unions seek the "pattern" of wage increases already obtained by the larger.

The hopeful view of the outlook is that such a calamity as a general shutdown due either to exhaustion of coal stocks or a railway strike cannot possibly be allowed to happen, and that settlements will be reached before it can occur.

Price Trends and Problems

Meanwhile attention is centering increasingly on price trends and problems. In both the trade figures, as already mentioned, in public psychology, and in the course of prices the workings of inflation are plain. The wholesale price index of the U.S. Bureau of Labor Statistics rose only 2.3 per cent during all of 1945 and from the end of November until early February this year the trend was sideways. Since then, however, over a period of eleven weeks the index has risen at a rate of 12 per cent per year while in the four weeks ended April 20 the rate of increase was 15 per cent per year.

Further rises are in prospect. The general view is that settlement of the coal strike will result in an increase of 30 to 50 cents per ton in the price of soft coal. The railroads, faced with retroactive wage increases of at least 16c an hour and possibly more, have applied for a 25 per cent increase in freight rates. These increases — like those following other wage raises — are necessary to sustain production and transportation, but both higher coal and higher freight rates will add to industrial costs and must affect prices.

The O.P.A. Controversy

The controversy over the extension of price control is understandably heated and violent, because it arises from the clash of two strong opposing beliefs. At one extreme are the believers in the planned economy doctrine, supported by others who perhaps are not much influenced by doctrine but who put above all else their fear of extreme price advances followed by calamitous declines later. On the other side are the believers in the free market, who rest their case on the restriction and distortion of production caused by price controls, and who are convinced that under the controls the economic system cannot produce all that is needed. They view the controls as self-perpetuating because of their effects on production, and would wipe them out now.

The action of the House with respect to continuing the Office of Price Administration is evidence that the legislators are of two minds on this perplexing question. They want to keep OPA alive and functioning for a time, but they also want to make sure that its deficiencies, both of administration and policy, are rectified, and that the agency will put itself out of business as rapidly as possible. For the latter purpose the House adopted an amendment (among others) to the act which would require immediate decontrol of a commodity when its production over a twelve months' period equalled the production in the twelve months July 1, 1940 to June 30, 1941.

This amendment is subject to the criticism which invariably arises from the use of a historical base, namely, that conditions now are not the same as in the base period. There is no allowance for increased demand and consumer buying power, or for the shifts of consumer wants as between one type of product and another. Considering the deferred replacement needs for so many kinds of goods, the inventory requirements, and the current buying power resulting from increased savings and income, 1940-41 average production today would in most lines still leave a gap between supply and demand. Moreover, such a formula can take no consideration of differences in pricing among various industries and markets. In some industries the pricing process approaches that of an auction in which the goods go to the highest bidder. In others, such as automobiles, a high degree of stability is maintained by the manufacturers themselves. Premature decontrol would be more likely to be followed by violent price instability in the former type of industry than in the latter; but under the formula decontrol would come immediately or in the near future in some industries of the first type and in basic materials and farm commodities which are now so scarce, while automobiles might be one of the last articles to be freed.

Criticism of the formula, however, does not signify that the revolt of the House against OPA policies is not healthy and beneficial. The testimony presented during the House hearings as to the effects of OPA pricing since the end of the war — such as the elimination of established low-cost production while new producers were permitted to make the same article to sell at high prices — should remove any lingering belief that price controls are inherently desirable. Congress has been properly and profoundly impressed by this evidence.

If Congress elects to extend the life of OPA, it is altogether desirable that it should limit the policies and practices which are distorting and restricting production. It is equally desirable that the extension should be written

in terms which make it clear that the lease on life is limited, and that the purpose is only to give time for an orderly rather than a violent transition to free markets, — including as a part of the transition the orderly elimination of subsidies. Whether decontrol can best be accomplished in an orderly way by writing an improved formula into the act, or whether it would be better to rely on a strong directive and to lodge in some other part of the executive authority the power to see that the administrator carried out the directive in letter and spirit, is for the Senate to decide. But it is important that the declaration of the intent of Congress should be unequivocal.

Denunciation of the House action by OPA officials does not help the situation. What is needed is all-around cooperation in working out a program to use the transition period wisely and effectively, — not to fasten controls on the economy, but to remove them in an orderly way.

First Quarter Earnings

Corporation earnings reports for the first quarter show, as was to be expected, extremely wide and uneven changes as compared with a year ago. In many industries production has been curtailed by reconversion and by strikes. In other lines, output has expanded to new high levels. Retail sales have broken all records. Elimination of the wartime excess profits taxes in many cases has resulted in substantial increases in net after taxes. Railroad income has been squeezed between falling revenues and rising costs.

These irregularities are reflected in the accompanying tabulation of first quarter earnings of leading corporations in the manufacturing, mining, trade and service industries. In many of the consumers' goods lines, such as food products, chemicals, and paper, a majority of the reporting companies show an increase in net income, due both to high operations and to elimination of the excess profits tax which offset rising costs. At the same time, in most of the heavy industries, such as iron and steel, automobiles, electrical equipment, and machinery, the strikes, reconversion difficulties and scarcity of materials caused earnings to drop sharply and deficits to be incurred in many cases.

For the 300 corporations here summarized, total net income in the first quarter of this year was approximately $217 million after taxes, which compares with $321 million in the preceding quarter, and is 32 per cent below the $320 million in the first quarter of 1945. Although 174 companies showed increases over the first quarter last year, against 126 showing decreases, the dollar totals were pulled down by the severe decline in steel and a number of other industries. For the manufacturing groups alone, the first quarter decline was 41 per cent. The figures are after deduction of deficits, which numbered 52 this year against 6 last year.

Net worth of these companies at the beginning of 1946 totaled $14,448 million, upon which first quarter earnings represented an annual rate of 6.0 per cent, compared with a net worth of $14,059 million in 1945 and a rate of 9.1 per cent.

NET INCOME OF LEADING CORPORATIONS FOR THE FIRST QUARTER

Net Income is Shown as Reported — after Depreciation, Interest, Taxes, and Other Charges and Reserves, but before Dividends. Net Worth Includes Book Value of Outstanding Preferred and Common Stock and Surplus Account at Beginning of Each Year.

(In Thousands of Dollars)

No. of Cos.	Industrial Groups	Net Income First Quarter 1945	Net Income First Quarter 1946	Per Cent Change †	Net Worth January 1 1945	Net Worth January 1 1946	Annual Rate of Return % 1945	Annual Rate of Return % 1946
22	Food products	$ 20,805	$ 24,308	+16.8	$ 731,431	$ 734,294	11.4	13.2
18	Pulp and paper products	4,473	7,361	+64.6	272,735	284,484	6.6	10.3
30	Chemicals, drugs, etc.	51,227	72,264	+41.1	1,788,325	1,835,734	11.5	15.7
9	Petroleum products	58,922	51,818	—12.1	2,571,630	2,723,450	9.2	7.6
15	Cement, glass, stone	9,297	6,007	—35.4	443,278	461,158	8.4	5.2
22	Iron and steel	39,973	19,855	—50.3	3,162,614	3,187,302	5.1	2.5
7	Electrical equipment	13,707	d-16,184	—	417,832	445,159	13.1	....
20	Machinery	8,842	d- 445	—	357,989	362,489	9.9	....
24	Autos and equipment	50,073	d-38,850	—	1,678,970	1,751,471	11.9	....
43	Other metal products	18,083	12,074	—33.2	828,577	849,232	8.7	5.7
40	Miscellaneous mfg.	20,127	36,851	+83.1	596,881	649,053	13.5	22.7
250	Total manufacturing	295,529	175,059	—40.8	12,850,262	13,283,826	9.2	5.3
21	Mining and quarrying	11,195*	9,347*	—16.5	514,941	446,145	8.7	8.4
18	Trade (whol. and retail)	9,919	26,925	+	522,839	543,607	7.6	19.8
11	Service	3,605	5,233	+45.2	171,272	174,602	8.4	12.0
300	Total	$320,248	$216,564	—32.4	$14,059,314	$14,448,180	9.1	6.0

* Before depletion charges in some cases. † Increases or decreases of more than 100 per cent not computed. d-Deficit.

Because of the abnormal conditions prevailing in many industries, first quarter earnings are not a reliable indication as to results during the balance of the year. Companies held back by strikes that have now been settled should recover their volume rapidly; they have heavy backlogs of actual and potential orders to assure high-level operations for a long period ahead, barring unforeseen interruptions. On the other hand, the long-term effect upon earnings of the wage increases granted this year in most cases was not yet fully reflected in the first quarter. In numerous instances the decline in first quarter earnings this year was cushioned, and in a sense obscured, by tax credits arising from the "carry-back" of unused excess profits tax credits or of net operating deficits against taxes paid in the two preceding years. While this tax provision will serve its intended purpose of aiding business in meeting reconversion expenses and losses, such credits may be used once only and thus are not to be regarded as a regularly recurring source of relief.

Due to the limited number of quarterly reports that are published, and the fact that they comprise mostly the larger manufacturing organizations, the results here summarized are not necessarily representative of conditions among the large number of small businesses throughout the country, many of which have been relatively harder hit by the loss of war business and the difficulties of reestablishing peacetime production.

Squeeze in Railroad Earnings

Railroad earnings, not shown in the table, were squeezed between a substantial decline in traffic and a sharp rise in expenses. While passenger travel continued heavy, total revenues were down 16 per cent from the first quarter of 1945, due to the ending of war shipments and to strikes in the steel, automobile and other industries. Wages were raised by a government "fact-finding board" an average of 16 cents per hour on April 3, retroactive to January 1, 1946, and a number of the unions have just filed demands for an additional 14 cents per hour. Cost of the increase already granted, if applied to all employes (except executives, general officers, and assistants) of all class 1 systems is estimated by the Interstate Commerce Commission's Bureau of Transport Economics and Statistics at $658 million annually, or more than the railroad's entire net income last year. From 1940 to 1945, average annual compensation per railway employee increased from approximately $1,900 to $2,700, while straight-time hourly earnings, including the increase granted this year, have risen since 1940 by 49 per cent.

Net income for the first quarter, after taxes and after deduction of deficits by a number of important roads, was but 32 per cent of that last year, 21 per cent of 1943 when a wartime emergency increase in freight rates authorized by the I.C.C. was cancelled, and the lowest for any first quarter since the net deficit level of 1940. Results since April 1st have been adversely affected by the coal strike. In view of these conditions, prompt action is imperative on the railroads' application now pending for a 25 per cent increase in freight rates, which are still around the prewar level.

A Sample of "Industry Profits"

Chester Bowles, former Director of OPA and now Director of the Office of Economic Stabilization, presented in the New York Times of March 24 his replies to six questions put by that newspaper on the controversial subject of continuing OPA controls over prices, rents and business profits. In answering the vital question "Is price control interfering with business profits?" Mr. Bowles cited the following illustrations:

> For the last four years of war — all of them under price control — we know that profits of all business groups were at record heights. Take the last full war year, 1944. Here is a typical sample of industry profits, before taxes, in that year, under price control, compared with prewar (1936-39) earnings: meat packers' profits, up 566 per cent; cotton textile mill profits, up 1,100 per cent; garment manufacturers' profits, up 280 per cent; shoe manufacturers' profits, up 140 per cent; department store profits, up 400 per cent for larger stores to over 1,000 per cent for smaller stores.

These illustrations — described as "typical" — suggest that profits are not only excessive, but have risen to almost unbelievable heights. Business men, finding it impossible to reconcile the large percentage increases with their own experience, know that such figures distort the true profit showing, but the general public may be misled. In fact, the high percentage increases reflect chiefly the method of calculation. In the first place, the increase is computed from a depressed base period, when many companies in the respective industries were operating at deficits or barely breaking even. Second, the computed "profits" are taken *before* taxes, and ignore the wartime increase in taxes. The distortion of real earnings caused thereby may be seen by taking a closer look at Mr. Bowles' illustration No. 1 — meat packing.

In that industry, according to Mr. Bowles, the profits, before taxes, in 1944 were 566 per cent above the 1936-39 average. If we take the net income after taxes, however, of about twenty leading meat packing companies — including the "Big Four" of Swift, Armour, Wilson and Cudahy — the rates of return on net worth since 1936 were as follows. For comparison, the average for all leading manufacturing companies, numbering around 1,400, is given also.

Year	Return on Net Worth: Meat Packing	Return on Net Worth: All Mfg.	Year	Return on Net Worth: Meat Packing	Return on Net Worth: All Mfg.
1936	5.5%	10.4%	1940	5.6%	10.3%
1937	3.2	10.8	1941	8.8	12.4
1938	Def. 1.0	4.8	1942	8.3	10.1
1939	4.9	8.5	1943	7.9	9.9
	——	——	1944	7.6	9.8
1936-39 Ave.	3.1	8.6	1945	5.4	9.1

Meat packing earnings for years have run consistently below the average for manufacturing companies generally, and were less than half that average in the OPA base period 1936-39. It might be added that the 1945 annual reports of meat packing companies, most of which covered fiscal years ending October 31 and were already published before Mr. Bowles' statement, showed net earnings one-fourth lower than in 1944. While the assertion by a government official that meat packing "profits" increased by 566 per cent is startling to the public mind, it is hardly as informative as would be a statement that net return rose from a depressed 1936-39 average of 3.1 per cent to 8.8 in 1941, but has since declined each year, despite a greatly expanded volume of sales, to 5.4 per cent in 1945.

The wartime increase in net earnings did not result from larger profit margins on the product handled, but from the heavy expansion in volume of sales, which at the 1944 peak were just double the 1936-39 level. Business needs better-than-average earnings in times of above-average production, if it is to have reserves to carry through less active periods, and to finance growth and improvement. The cost to the public of its services rendered is not measured by what the industry earns on net worth, but by how much it takes out of the sales dollar. In both 1944 and 1945 the leading meat packing companies showed net income after taxes (including income from investments and other sources as well as from sales) averaging but 9/10 of one cent per dollar of sales. During the years 1933-45, the group margin ranged from a high of 1.6 cents to a deficit of 3/10 of one cent, with an overall average for the thirteen-year period of but 1.05 cents.

The record of American meat packing in mass production and distribution, maintenance of quality standards, recovery of by-products, and low cost to the public is probably unexcelled by any industry in any society, whether capitalist, socialist, or communist. But out of their traditionally slim profit margin the meat packing companies recently were forced, through government seizure and wage awards, to "absorb" part of a 16 cents per hour increase in labor costs. Within the past few months a number of the smaller packing companies have completely suspended operations and many others have had to curtail sharply, either because of losing money under existing price ceilings or because of inability to obtain livestock in competition with unlicensed slaughter houses buying and selling in the black market.

As to Mr. Bowles' "typical" illustration No. 2 — cotton textile mill profits up 1,100 per cent — the record of net earnings shows a pattern similar to that of meat packing. In the OPA base period 1936-39 the average return shown by the published reports of about forty leading cotton mills was 2.9 per cent, compared with the average of 8.6 for all leading manufacturing companies. In 1941, as a result of huge expansion in demand for textile products, the average return rose to 12.1 per cent, then declined to 7.1 per cent in 1944 and rose slightly, to 7.7 per cent, in 1945. Average net profit margin last year was 3.3 cents per dollar of sales.

These narrow operating margins in meat packing and cotton goods are representative of conditions in many other industries. Since business earnings play a prominent part in arguments over inflation and in policy decisions, it is essential to get the true facts and to use care in their interpretation. As Mr. Bowles declared — in introducing his illustrations quoted above and referring to a statement by the National Association of Manufacturers that "business cannot live by producing at a loss," — "Now, let's get that charge in its proper perspective, too." People have a right to expect from government officials, as from all responsible persons, fair statements of facts, and figures which represent situations in their true light.

Debt Retirement and Money Market

On April 11 President Truman gave official confirmation to forecasts that the federal deficit for the current fiscal year would be a good deal smaller than the $28 billion projected in his annual budget message last January. Of the $21.7 billion deficit now forecast for this fiscal year, $18.1 billion was incurred in the six months ended last December, followed by an actual surplus of $800 million in the March quarter, leaving an indicated deficit of $4.4 billion for the June quarter, with improved outlook for a balanced budget in fiscal 1947.

This marked betterment in the budget position is making possible a speeding up of the program of debt retirement out of the proceeds of the Victory Loan. Including $1,579 million of certificates to be paid off in cash on May 1, total redemptions of public marketable government obligations since February 28 total nearly $6.4 billion. Secretary Vinson recently stated that "the size of the Treasury's cash balance will permit us to pay off other maturing securities from time to time as we find it convenient and desirable."

Reflecting the effect of Treasury redemptions upon bank credit, there was between March 1 and April 10 a net decrease of $2.8 billion in the government security holdings of the weekly reporting member banks and of $740 million in the Federal Reserve Bank holdings. During the same period the government deposits in the weekly reporting member banks were down $2.6 billion, but there was no corresponding increase in private deposits. The net changes are shown in the following table:

Changes in Holdings of Government Securities and Deposits
February 27 to April 10, 1946
(In Millions of Dollars)

Government Securities	F. R. Banks	Weekly reporting Member Banks	Nonreporting banks and other holders (computed)	Total outstanding
Bills	+ 373	— 274	— 99	0
Certificates	—1159	—1616	— 230	—3005
Notes	+ 90	— 847	— 533	—1290
Bonds	— 44	— 92	— 353	— 489
	— 740	—2829	—1215	—4784
Deposits				
U.S. Government		—2557		
Demand (adjusted)		— 351		

Preferential Discount Rates Eliminated

As a further step in checking credit expansion based on Government securites, the boards of directors of three of the regional Reserve Banks — New York, Philadelphia, and San Francisco — eliminated effective April 25 the preferential discount rate of ½ of 1 per cent on advances to member banks secured by governments maturing or callable in one year or less, thus making the regular discount rate of 1 per cent applicable to this class of borrowing. This action — which, to be effective, required approval by the Board of Governors of the Federal Reserve System at Washington — was followed by other Reserve Banks, and soon all are expected to fall in line.

The preferential discount rates, established by all of the Reserve Banks in October 1942, were designed to encourage banks to make fuller use of their available excess reserves to help in financing the war. Though, actually, no great amount of member borrowing had developed, the elimination of these special rates reflects the official feeling that this is no time to be offering inducement to banks to borrow to extend credits. In approving the rate changes, the Board of Governors said in part:

The Government's program no longer calls for expansion of bank credit to help finance huge war expenditures. Instead, it calls for action that will stop additions to and bring about reductions in the country's monetary supply in order to reduce inflationary pressures.

The Board also stated that it "does not favor a higher level of interest rates on U.S. securities than the Government is now paying," and that "discontinuance of the special rate will not involve any increase in the cost to the Government of carrying the public debt." This statement, involving apparently a continuing commitment by the Reserve Banks to the wartime interest rate pattern, raises a question as to how far maintenance of this pattern is compatible with the objective of controlling credit expansion.

Reaction in Government Security Prices

The above-mentioned actions by the monetary authorities, in using Treasury war loan balances to pay off debt and in eliminating the Federal Reserve preferential discount rates, were accompanied by a sharp reaction in government security prices from their recent highs. With many banks under the necessity of adjusting their reserve positions to meet Treasury withdrawals, bank selling brought pressure upon short- and medium-term issues. Yields on certificates increased from the mid-February low range of 0.40-0.77 per cent to 0.83 per cent, while the 2s of December 1952-54 reacted in price from the March high of 105 1/32 to 103 23/32, with consequent increase in yield from 1.22 to 1.41 per cent.

Factors affecting the longer-term bonds not eligible for bank holdings were the reaction in bank eligibles, plus the high prices which had been attained. On April 6, for example, the 22-27 year Victory Loan 2½s touched 106 17/32 at which the yield was but 2.12 per cent. This offered greatly reduced incentive for purchases and increased inducement for profit-taking, especially in view of expected liquidation of speculative holdings following the expiration of the six months period from date of purchase, when lower income taxes on profits would apply and when bank loans to carry securities fall due. Reflecting these influences, the price of that issue declined with little interruption to 103 3/32 by the end of April, increasing the yield to 2.32 per cent. There was some rallying from these low points.

Credit and Fiscal Policy in Inflation

Now that the country generally recognizes that the condition with which it has to deal is one of inflation rather than deflation, discussion has shifted to ways of fighting inflation. As always in times of inflation, the popular tendency is to stress direct price controls. The public press is full of the violent controversy over continuing OPA. From the nature of the discussion one might suppose that the argument over OPA is all there is to the inflation problem.

Actually, the fight against inflation is a many-sided problem. While direct controls have, of course, their place in this battle, they

cannot be expected to do the job alone for the simple reason that they do not go to the roots of the inflationary pressures. Price controls represent an attempt to deal with consequences rather than prime causes. The prime causes, it would seem clear, are twofold:

(1) The attempt by various pressure groups – farmers, business men, and organized labor — to take advantage of the tight demand-supply situation, or of strong political influence, or both, to advance their own interests at the expense of other groups in the community. The aggressive attitude of certain strongly entrenched labor groups, with government encouragement, has been particularly influential in forcing up prices and starting an inflationary wage-price spiral. This experience illustrates a basic difficulty about the much-discussed "full employment" theory — namely, that of reconciling a program of government spending for full employment with the objective of maintaining price stability.

(2) The huge increase in the volume of credit brought about by the war, supplemented by a continuing high level of individual income payments. This means a tremendous aggregate purchasing power in the hands of the people at a time when there is still a scarcity of things people are wanting to buy and production is not yet fully under way.

Of these two causes of inflation, the second is the more basic, since it is the excess of means of payment — in the form of bank deposits and currency — to available goods and services that creates the setting in which pressure groups are best able to put over their demands. Because of this crucial importance of purchasing power in the inflation problem, it is essential to check the expansion of credit, and indeed to reduce the amount now outstanding, if anti-inflationary policies in other directions are to be effective.

The Task of Financial Reconversion

Obviously, the first step in this direction is the restoration of a balanced budget and elimination of deficit financing, and the commencement of the retirement of debt, at the earliest possible moment. This is true for two reasons — first, the federal deficit and dependence of deficit financing upon the banking system has itself been the chief cause of the expansion of bank deposits and purchasing power; and, second, because elimination of the deficit would give the monetary authorities a freer hand in applying policies of credit control.

Happily, the latest indications on this score are encouraging. Due to the rapid reduction of war expenditures and the continued high level of revenue receipts, the gap between federal outgo and income has, as reported elsewhere in this Letter, been rapidly narrowing, with the January-March 1946 quarter showing a surplus of revenue over expenditure for the first time in sixteen years. While the current quarter is expected to show a deficit the President now expresses the hope for a balanced budget for the fiscal year 1947.

This is all to the good, for it means that if these expectations are realized the budget will cease to be a source of inflationary pressure. Indeed, including social security taxes collected from the public for investment in government trust funds but not counted as revenue receipts, government finances would be showing an actual surplus of cash collections over cash disbursements.

But we ought not be satisfied with a mere balancing of the budget and halting of the growth of debt. Now, if ever, is the time when we should be achieving a surplus of revenue for debt retirement in the interest both of lightening the future tax burden and of lessening the present inflationary pressures. The sound way of doing this is by getting expenditures down to levels that will produce a surplus for debt reduction and at the same time leave room for some tax relief that is so urgently needed to preserve the incentive for work and enterprise.

Credit Policy and Debt Management

The second step in financial reconversion is a readjustment of the Government's policies with respect to credit and management of the public debt. These policies have proved inflationary on two counts, (1) in promoting "monetization" of the debt, i.e., lodgment of government securities in the banking system with consequent expansion of bank deposits usable as cash, and (2) though intended to stabilize interest rates, these policies have in fact operated to drive them down, with corresponding inflationary effects in capital values of bonds, stocks, real estate, and commodities.

A pattern of interest rates ranging from ⅜ of 1 per cent for Treasury bills up to 2½ per cent for the longest-term bonds was established at the outset of the war, and facilities were provided by the Reserve Banks for maintaining it and for supplying the funds needed for war financing. This program was a cooperative undertaking, agreed to generally by the banks, by the Treasury, and by the Federal Reserve. It worked well during the greater part of the war period, but early in 1945 began to go haywire.

With the Treasury bill rate pegged down by the Reserve Banks to ⅜ of 1 per cent, and with certificates generally yielding less than ⅞ of 1 per cent, investors naturally were encouraged to reach out for the longer-term higher-coupon issues as confidence grew in the Government's

ability to keep interest rates generally from rising. In the process of this shifting, commercial banks sold, or borrowed against, their low-yielding short governments at the Reserve Banks, thus calling into use additional Federal Reserve credit which, spreading out as reserves through the banking system, made possible further multiple expansion of credit through the medium of additional government bond purchases by the banks. When the Treasury attempted to control this situation by limiting the supply of new Treasury issues eligible for commercial bank holding, the effect was merely to intensify the scramble for issues already outstanding and drive prices higher and yields lower. Thus, early this year the 8-10 year Treasury 2s offered originally at the end of 1944 at par were down to a 1.22 per cent basis.

While yields of long-term governments not eligible for commercial bank purchase were held relatively firm during 1945 by the continued availability of new issues in the bond drives, these too joined the downward procession following the close of the Victory Loan when the approach towards a balanced budget appeared to forecast an ending of the offering of Treasury securities for new money and when the Treasury appeared to be adopting a policy of refunding all maturing debt with short-term certificates.

All this was having widespread effects upon the economy. Not only was it contributing directly to banking inflation, but it was exerting a profound influence upon the entire structure of interest rates, and creating serious problems for insurance companies, savings banks, and other institutions and individuals dependent upon investment income. It was an incitement to speculation generally, for if people cannot get decent returns on sound investments they will take chances on riskier ones. In fact, the inflationary consequences were far-reaching.

The Dilemma of Interest Rate Policy

Both the Treasury and the Federal Reserve authorities have recognized these dangers, and Federal Reserve officials, in particular, have been outspoken in urging measures for curbing the continued expansion of bank credit through government security purchases and for checking the decline in interest rates. But they have found themselves facing a dilemma. Whereas always in the past the traditional method of controlling expansion has been to allow a tightening of the money market, the authorities are not wanting to accept an upward movement of interest rates that would increase the already heavy cost of carrying the national debt. Also, there has been the political argument that higher interest rates would increase unduly the earnings of the commercial banks, and the argument that low interest rates are desirable for stimulating business.

This is a difficult dilemma, and one that has led to a number of suggestions — so far unofficial — for new banking legislation for dealing with the situation. Among these is the so-called "certificate reserve" plan, of which several variants have been proposed. In general, however, what the plan in its various forms boils down to is that commercial banks be required to keep a specified minimum proportion of their deposits invested in low-interest Treasury certificates. The argument advanced is that this would curb the sale by the banks of short-term securities to the Reserve Banks and purchase of longer-term higher-yielding issues in the market. Also, it is argued, the plan would assure a low interest cost to the Government on that portion of the debt held by the commercial banks.

The "Certificate Reserve" Plan

While space here available does not permit of detailed analysis of this plan, a brief comment is in order. In the first place, though the technical problems are many, most of the discussion has been in terms of broad outlines and objectives. In none of the proposals has there been any adequate public explanation by its proponents as to just how it would work out in practice. Banks, for example, differ greatly in the percentage of their deposits used in commercial loans and in governments, their requirements for earnings, their need for liquidity, etc. Some banks have as large loans as they have governments, while others have three or four times as much governments as loans. Hence any fixed percentage of required "certificate reserve" would be unfairly high for some banks, while having no limiting effect on the operations of others. Apparently the very banks most active in commercial lending would be penalized the most. The plan, in short, would seem to apply a plaster over the entire banking system, regardless of the position of individual institutions.

A second point is that, whereas the goal is supposed to be to limit the growth of bank holdings of governments and consequent expansion of credit, it might actually have the opposite effect. For if commercial loans increase in the postwar period with the revival of normal business and bring about an increase in deposits, banks would be *required* to cover a portion of such deposit increase with special certificates purchased from the Treasury as well as with the usual reserve at the Federal Reserve Bank. Unless the Treasury, however, were to lock up the proceeds of certificate sales and not spend them into the market, the effect would be to cause a *further* increase in

deposits requiring in turn both further increase in Federal Reserve credit and further certificate purchases by the banks, thus leading again to further increase in deposits, and so on in a pyramiding effect. For the Treasury, on the other hand, to "sterilize" the proceeds of certificate sales by not spending them, would mean borrowing money and paying interest on it only to hold it idle — a procedure not likely to be popular politically.

Apart from such mechanical problems, there is the question as to whether the plan does not make government borrowing too easy in providing the Treasury with this inside track to the banking system without test of the marketability of government credit. The fact is that no one can foresee the full ramifications of so complicated and revolutionary a scheme. One thing, however, is clear — it would vastly increase the power of the Government, and particularly of the Treasury, over the banking system. It is more regimentation. It is fair to say that the serious discussion of radical new legislation of the sort has been disturbing to the banking situation, and has for example made it more difficult for banks to increase their capital funds by the sale of stock.

Still another suggestion for new banking legislation — that the Federal Reserve Board be given additional powers for raising member bank reserve requirements — seems directed more towards some future possibility of bank excess reserves getting out of hand than towards the present situation, since any use of such powers under present conditions would obviously affect interest rates. But with the Reserve Banks now holding $22 billion of government securities which they could sell in order to mop up excess reserves, it is difficult to see the need for such powers over the predictable future.

A Program Emerging

A fundamental objection to all such schemes and proposals is that they fail to take account of what can be done within the powers which the authorities already have. It is not a question of needing new powers, but of willingness and courage to use those already at hand. It is encouraging, therefore, to find the authorities tending to use those instruments which they have.

The first step in the program now apparently emerging is the balancing of the budget and ending of deficit financing, to which we have already made reference.

The second is the Treasury policy of using excess cash built up by the Victory Loan to retire debt. This has the effect of reducing bank holdings of government securities, and, while also reducing bank earnings to some extent, is a sound step in that it has the anti-inflationary effect of reducing bank deposits which are potential buying power.

The third step is the action last month by the Reserve Banks in ending the ½ of 1 per cent preferential discount rate on loans secured by short-term governments and making the regular 1 per cent rate the effective rate. While the preferential rate had a useful purpose during the war in encouraging banks to carry their share of government financing, its continuance now would be illogical, unwise, and an invitation to inflation when the need is to reduce credit expansion.

These measures appear to be having a salutary influence both in checking the inflation of bank deposits, as indicated on page 54 of this Letter, and in taking some of the speculative fever out of the government bond market, with consequent lessening of pressure upon interest rates. Additional measures that might well be included in the program were suggested in a statement issued last month by the Executive Council of the American Bankers Association to the Association membership. This statement, besides approving the measures outlined above, contained the following recommendations:

(a) The continued vigorous sale of Treasury savings bonds by the banks is of the greatest importance in combating inflation. This program should include plans to persuade bondholders to keep their bonds.

(b) Refunding bonds of long term should be offered from time to time to non-bank investors. Accumulating institutional and private funds provide an opportunity for the Treasury to carry further the refunding of debt held by the banks into the hands of non-bank investors. To do this it is necessary that the Treasury, in addition to the savings bond issues, should make offerings of bonds that have a maturity and rate to appeal to such investors.

(c) Steps should be taken to reduce speculation in government securities. The banks can do something to improve this condition by reviewing carefully their own loans on government securities, particularly the loans that were made on securities issued in the Victory Loan drive. The banks certified to the Treasury in connection with every subscription that loans against these securities were of a type that could be liquidated within six months. Those six months will elapse by June 8. Banks have an obligation to review these and other loans on government securities carefully to see that they are not encouraging speculation in such securities.

On Determining Sound Interest Rate Policy

With a program of this kind, and with the Treasury, the Federal Reserve, and the commercial banks working together, it is possible that control over the monetary aspects of the inflation problem may not prove incompatible with maintenance of low interest rates and the objective of holding down the cost of the debt service. However, a level and pattern of interest rates that can be held without unduly expanding credit and stimulating inflation is not something that can be picked arbitrarily out of the air. It has to fit the conditions. The idea that any increase in interest rates would be a calamity, or that credit

policy should be determined by what happens to bank earnings, is getting things all out of focus.

Maintenance of sound credit conditions is very much more important in the long run than low rates for borrowing or low rates for business. The great enemy of prosperity in this country has been the alternating cycles of inflation and deflation. What is to be avoided at all costs is the boom followed by the crash.

The Grain Crisis

The change in the position of wheat and feed grains from one of seeming plenty to an acute shortage has come so rapidly that in many quarters there is a sense of bewilderment. Wheat went through the war in a surplus position. But in the first year of peace, and in the same season in which the country harvested its largest wheat crop, a bread scarcity impends. The stock of wheat in the country on April 1, according to the Crop Reporting Board, was only 339 million bushels. Since the carryover can hardly be drawn below 90 million, only 250 million are left for the April-June quarter. The export goal for the quarter is 125 million. If this is met the cut in domestic consumption (excluding seed) below the January-March quarter will have to be around 50 per cent.

Most people probably attribute the crisis wholly to the demand for American wheat to feed starving people abroad. Actually, however, it is the unexpected amount of wheat used at home which has upset calculations. Our commitment to export 425 million bushels of wheat was made early last winter, when the supply was thought to be ample to meet it fully, satisfy home needs, and still leave a comfortable carryover at the end of this season. This export quota has not been increased. But the domestic use of wheat has been far above expectations, — not in feeding people, but in feeding animals. In the first nine months of the season some 275 million bushels was fed to livestock, about twice as much as was anticipated when the export quota was fixed, and about three times as much as was usually fed in full seasons before the war.

It had become clear by January 1, when the mid-season stock report showed that more than half of the season's wheat supply was gone, that domestic use of wheat would have to be curtailed. But in the January-March quarter more than 100 million bushels was fed to livestock, an even higher rate than during the first half-season. Since March 1 one measure after another has been taken to curtail the use of wheat, but mostly on the milling side. The flour extraction rate has been increased, use of wheat in distilling and brewing banned, and manufacture of commercial wheat feeds limited. Finally, millers and food manufacturers were ordered late in April to curtail their use of wheat and flour immediately to 75 per cent of the amount used during the corresponding period of 1945. At the same time a realistic and promising effort was made to speed the movement of wheat off the farms; farmers were offered a bonus of 30c a bushel on all wheat delivered to the Commodity Credit Corporation before May 25, and a similar bonus on 50 million bushels of corn.

"Cheap Feed" Policy

While the amount of wheat saved by milling limitations is important in the emergency, it is small by comparison with that lost earlier in the season by excessive feeding to livestock. The mistake that has been made by the rigid maintenance of our wartime "cheap feed" policy, for too long a time, now stands revealed. Months ago grains should have been diverted from livestock and into human consumption to the extent which the world food crisis demanded.

During the war, when shipping was tight and the emphasis was on concentrated foodstuffs, price relationships between feed grains and livestock, poultry, and dairy products purposely were kept at levels which made conversion of grains into these products more profitable than their use for human consumption. This policy worked well, for output of meat, egg, and dairy products soared to record heights. Livestock numbers were built up to the limit of our feeding ability and in fact temporarily above that limit, for sharp cutbacks in hog and poultry numbers became necessary after 1943. Even so, the livestock population is still some 16 per cent greater, on a weighted average, than before the war.

With the end of the war, the food problem changed abruptly to a need for bulk grains. For only through such a shift could we expect to redeem the promise made to some 150 million Europeans, dependent upon imports, that along with their freedom they would be provided with necessary food. While livestock products furnish a superior food, the fact remains that from a caloric standpoint (and it is the calory yardstick which measures the difference between life and death when starvation threatens) grains will sustain seven to eight times as many lives when fed directly to human beings as when fed indirectly through livestock. According to the New York State College of Agriculture at Cornell University, meat production represents a caloric loss of some 85 per cent; for every 100 calories fed to animals, only about 15 calories are returned in the form of meat.

Far-Sighted Prophecies

Nearly three years ago the Cornell authorities pointed out that the number of people to be fed after the war would increase tremen-

dously and that if we were to be in a position to redeem our promises, we should have to use our grain for human consumption instead of livestock production. We quote below a passage from the June 1943 issue of their publication, "Farm Economics":

The only way that we can send much food to other countries is by sending our accumulated wheat stocks and by reducing our grain-consuming livestock so as to release for human consumption the grain that they would eat. The wheat stocks would disappear rapidly if we tried to feed many people. Any sustained help will have to come in the form of grain released from livestock feeding. If we are willing to do that, and consequently to shift our consumption "from pork chops to cornmeal", our ability to help feed the rest of the world is fairly impressive. But the help we can give will not amount to much on any other basis. Such a program calls for reduction, not increase, in the finish-feeding of livestock and in the production of products like poultry and eggs, and pork and lard. It is the opposite of the natural effects of present price policies which are freezing the hog-corn ratio at about 15. We cannot feed both increasing livestock numbers and starving Europeans. It would be nice to send them pork chops and butter, but neither they nor we can afford it.

At the Hot Springs Conference on food in 1943 the possibility of grain shortages after the war was recognized, and all countries were urged to increase their acreage in crops for direct human consumption. Mr. Bevin, the British Foreign Secretary, precisely diagnosed the danger last October, when he said in the House of Commons:

Additional supplies, on a scale sufficient to bring any widespread relief, must be organized on an international basis, with the cooperation, in particular, of the exporting countries. We must look to them to make a much bigger contribution. For instance, I should like to see much less wheat being fed to livestock in North America, and more corn and other foodstuffs shipped from South America.

Our commitment to export 425,000,000 bushels of wheat, made six months ago, recognized the gravity of food shortages abroad. We did not officially recognize, however, that this amount of wheat, plus our own bread needs, would not be available unless feeding of wheat to livestock was discouraged. Our grain-livestock price policy remained unchanged. For many months after the end of the war we continued the most intensive feeding practices ever known in this country. Hog weights, egg output per layer and milk production per cow all set new records.

Even after the warning of the January 1 figures there was no prompt action to make feeding less profitable, either by raising grain prices or lowering animal prices. The bonus of 30c a bushel to encourage farmers to sell wheat and corn instead of feeding it — announced only in late April — is the first real move in that direction. It is a subsidy out of the Federal Treasury, but at least it recognizes that the farmer, in deciding whether to sell or feed his grain, is influenced mainly by relative prices and profits.

The Outlook

While many believe the grain crisis will be largely relieved in 90 days, since the outlook for another bumper wheat crop in this country is fortunately promising, the duration of the emergency will be greatly affected by the outcome of harvests in other countries, particularly in Canada and Europe. For with reserves exhausted, only favorable harvests everywhere can relieve the strain. The outlook for reestablishment of normal rice production in the Far East is not encouraging, and needs in India are desperate.

The loss of wheat through excessive feeding is largely irrecoverable. The drastic steps now being taken to repair the damage can be only partially effective in making the loss good, and they have disturbing effects of their own. They disrupt the flour and bakery trades, they create problems of distribution possibly leading to black markets, and they will leave a residue of trouble after they are no longer needed. By a sound policy to discourage the excessive feeding of wheat to animals instead of to people, they might have been avoided.

Admittedly, such a policy would not have been an easy or agreeable one. The amount of meat and dairy products in the markets now is too little for our wants. But since world needs required the choice it should have been made and the understanding and cooperation of the American people relied upon to support it.

If there were a free market, in which the distribution of wheat among its various uses was governed by relative prices, no one would have to make unpopular and difficult decisions; they would be made automatically. Almost certainly human needs today would be outbidding animal needs, and feeding wheat to animals would be discouraged by wheat prices.

The lesson of the grain crisis is a lesson of the unreliability of prediction, and of the fallibility of controls and planning. Confronted by the present distorted price relationships, the allocations, the contentions, and the confusions over the world, the advocates of a minutely planned and controlled economy perhaps may think more kindly of the past, in which price governed distribution and in which the grain merchants of the world performed almost automatically, with a minimum of conscious planning, the task which today has us dissolved in confusion. This is not to say that grain and livestock controls should be entirely dropped at this time, for grave price disturbance and instability would almost certainly follow. But price relationships need to be brought into harmony with realities and needs. Their unrealistic character, for many months past, has been the primary cause of the current difficulties.

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